Assault on the Investor Class

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Can anyone be surprised that the Congressional tax committees have set their sights on the private equity market as a source for new tax revenues? This week Senators Max Baucus and Charles Grassley, the chairman and ranking minority member of the Finance Committee, will hold "informal meetings" to ponder a 133% tax hike on private equity firms.

There's no good rationale for this beyond the fact that Congress wants money and private equity funds have lots of it. Private equity firms will raise and deploy a record one-half trillion dollars of investment capital this year -- funds that provide start-up and expansion-phase money for firms large and small. These funds also engage in leveraged buy-outs of financially ailing companies or publicly traded corporations whose stock price may be undervalued. Toys "R" Us, Neiman Marcus, Dunkin' Donuts and Univision are just a few of the dozens of publicly traded firms snatched up in recent years by private equity firms.

Private equity assets have grown by three-fold in a decade, and perhaps because of the spectacular financial gains of firms like Blackstone Group and Carlyle Group the industry now has a political bull's-eye on its chest. These companies have been denounced by politicians as "swarms of locusts," by labor unions as "job killers" and by the media as tax shirkers. So an industry that now provides an estimated one of every five of the globe's investment dollars -- the financial sustenance that will allow infant 21st-century industries to mature -- has come to be stereotyped as modern-day Robber Barons.

Senator Grassley says he suspects "subterfuge" that allows fund managers to underpay their taxes. The managing partners of equity funds generally receive compensation in two ways. They charge the fund investors a 1% or 2% management fee for finding high-return business opportunities and for orchestrating the portfolio. Those fees are taxed at the personal income tax up to 35%. But fund managers also typically lay claim to a 20% slice of the fund's future profits. That return is called "carried interest" and is taxed at the long-term capital gain rate of 15%. Congress is considering reclassifying that income as labor compensation and taxing it at the 35% income tax rate.

That's bad tax policy for a lot of reasons. "Carried interest" is long-term, risk-based investment income derived from future profits. Those profits are anything but a sure thing. Private equity managers get nothing from their equity holding until investors get all of their money back plus a negotiated return -- which is a lot different than an upfront fee or a guaranteed wage or salary that comes as a paycheck every two weeks.

Far from being a clever tax dodge, carried interest plays a central role in the performance of private equity funds: It establishes an incentive structure which aligns the financial interests of the managers and investors. "Capital gain tax treatment of fund managers is not a 'loophole' that is being exploited by clever equity fund managers," explains a recent legal advisory by the law firm Nixon Peabody, "but is a well-established principle of partnership taxation that has been enshrined in the Internal Revenue Code for decades."

Overturning this tax doctrine would have negative effects on a wide spectrum of other investment funds which use "carried interest" incentive structures, including real estate and oil and gas partnerships, and venture capital firms. Doubling the tax rate on public equity will hurt them for sure, but the lower after-tax returns will undoubtedly mean fewer deals, which will do collateral damage to investors and entrepreneurs who depend on this capital for financial sustenance. Last year a record amount of private equity investment went into the coffers of family-owned businesses -- not multibillion dollar firms.

Despite their Gordon Gekko image, private equity funds were net creators of some 600,000 new jobs from 2000 to 2003, according to a study by the consulting firm A.T. Kearney. The biggest losers from a private equity tax hike may be pension funds, which have become large investors in these funds; their high performance has made millions of Americans wealthier in their retirement. The California public employee pension system is thought to be one of the largest private equity investors in the country.

Seen in a broader context, what we have here is the first skirmish in the political war over the Bush tax cuts and the future of capital gains and dividend taxes in the U.S. The left is eager to raise tax rates on capital gains to the same as personal income -- which would *double* the tax rate on *all* investment income. Already House Democrats have proposed ending the preferential tax rate for capital gains and dividends on those paying the Alternative Minimum Tax. A new "millionaire's" tax bracket of 40% is also envisioned. This new and higher tax burden would move the U.S. from a low investment tax regime to one of the highest in the world.

At a time when even Democrats like New York's Governor Eliot Spitzer and Senator Charles Schumer lament that America's status as the financial capital of the world is at risk from over-regulation and litigation, this would seem to be the worst time to make our tax laws less investor-friendly. The U.S. has enjoyed a sizeable lead in the world in private equity financing for the next generation of Googles, Microsofts and Home Depots. New investment taxes will drive that business offshore too.